

# MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC

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Dear Fellow Investors,

As you can see below, our investing results are very favorable this quarter and this year. Considering the turmoil that our economy has been through since we began investing in June 2008, we are very pleased to report positive returns since inception as well. However, we don't take these superior returns for granted. We will undoubtedly have periods in the future when our performance is not as good. The conclusion we hope you draw from these numbers – and the one we draw – is that disciplined long-term investing works. It works without borrowed money. It works without top-secret magic investing formulas. And it enables investors like us to build wealth, even in very difficult environments.

	<b>Q3 2009</b>	<b>2009 Year to Date</b>	<b>Annual Return Since Inception</b>
Midway Composite (net of fees)	19.64%	29.08%	1.45%
S&P 500 Index	15.60%	19.25%	-11.95%
Difference	+4.04	+9.83	+13.40

Data reflect total returns (including dividends) net of fees as of 9/30/2009. Returns are unaudited. Your individual returns reported on your statements may vary from the composite depending on when you invested and upon any special instructions or restrictions applicable to your account. The composite return is the time-weighted return of all our accounts added together into one big pool. We believe it is the best indication of how the average client fared over the past quarter.

## **Portfolio updates – Buys, holds, sells**

If you've been with us for a while, you haven't heard us talk much about selling. Indeed, we still think there are a lot of bargains in the stock market today so most of the stocks we hold are things we are still actively buying or holding until they reach a fair value. However, you may have noticed us doing a little selling of selected positions.

Knowing when to sell is probably the hardest part of investing. We haven't perfected the art of timing our sells, but we have a few disciplines in place. We sell when a position becomes too large, thereby concentrating too much risk in one security. In those cases, we usually sell only a portion of the position if we think that it is still undervalued. We also sell when we think a security is trading above its fair value, particularly if we think there are better bargains to be had elsewhere. In general, however, we like to buy companies that we would be happy owning for ten years or more, so we aim to simply buy good

companies and keep them. Still, if the market gets overheated at some point (and it probably will) and valuations no longer reflect reality, we will reduce our positions appropriately.

This recently happened with a few closed-end funds that we own. We like to buy these securities opportunistically because they are often mispriced relative to their underlying assets. Closed-end funds, unlike regular (open-end) mutual funds, cannot be redeemed at the value of their underlying holdings. They can only be sold to other investors. When investors become pessimistic, they are often willing to sell their funds for less than they are worth. It is rather like selling your ticket to a ball game. Say you paid \$50 for it. If your team is doing really well, the weather is beautiful, and the game is sold out, another fan might give you more than \$50 for it. On the other hand, if the weather is lousy and your team is too, you might be lucky to get \$25. Investors often sell closed-end funds when they perceive lousy weather ahead, often at less than their net asset values (NAVs). If we think the assets in the fund are likely to appreciate in value and the discount is good (we like 20% or better), then we will buy an occasional closed-end fund.

In the case of the fund we have recently been selling, we had bought it at a substantial discount to NAV, but the shares were changing hands at a 12%-13% premium, so we were content to sell it to other investors whose optimism was running high. We might possibly buy it back if it looks cheap again. We are opportunistic buyers of closed-end funds, and though they aren't the main focus of our investing, we will continue to buy them when the price/value disparity is compelling.

### **Portfolio updates – The Legg Mason tender**

Nearly all of our portfolios hold **Legg Mason (LM)** common stock or **Legg Mason Equity Units (LMI)**. We have thought that Legg Mason (the company itself) is worth significantly more than the market is paying, and we still do. In July, Legg Mason offered to buy up its outstanding Equity Units (LMI) for \$6.25 in cash and 0.881 shares of LM stock. We turned down this offer. Here is why.

The Equity Units are really two securities. One is a bond paying a 9.6% yield (at today's price). The other is a forward contract to buy one share of LM stock. If we keep the Equity Units until they mature in 2011, we will have the share of stock, PLUS, we will pocket a 9.6% yield each year from now till then.

If we had taken Legg's offer, we would have gotten 0.881 shares of LM stock (less than a full share) and the \$6.25 cash payment. This would have resulted in a net gain of \$1.93 per share (See Exhibit A). That doesn't begin to compensate us for two years of interest payments (\$7 per share) we will receive just by hanging onto our bonds, and the fact that we don't get a full share of LM in the exchange. As long-term investors who would like to continue to hold LMI, the choice was easy<sup>1</sup>.

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<sup>1</sup> LMI is a complex security. This deal would only have been good for us if LM stock was worth less than \$7.25 per share, an unlikely proposition, or if a spike in interest rates or credit downgrade meant that the company would need to make a substantial cash outlay to settle the forward contract. In our opinion, it is extremely unlikely such a large shift in the price of the bonds would occur such that it would be advantageous to receive only 0.881 shares of LM. Note that if the price of LM shares rises significantly, the forward contract price rises as well, capped to a maximum of \$67.56. But that effect is likely minor given the current trading price (\$30.90) of LM stock.

Given this analysis, why were 91% of the LMI units sold back to Legg Mason? We suspect it is another example of investors sacrificing bigger long-term profits for short-term gains. Only July 15, 2009, LM closed at \$24.89 and LMI closed at \$26.25. Tendering the units resulted in an instant gain of \$1.93 (see Exhibit A). But it also sacrificed much greater long-term value.

#### **Exhibit A**

Don't tender: 1 share LMI = \$26.25

Tender: \$6.25 + 0.881 share of LM = \$6.25 +(0.881\*\$24.89) = \$28.17

Difference: \$28.17 - \$26.25 = \$1.93

#### **How much does the management team matter?**

We often say that we like to buy companies that are well managed. Does that mean we are looking for flawless management teams? Certainly, we'd like that. But life is full of uncertainty and not one of us can make decisions without making mistakes; expecting perfection usually leads to disappointment. In our view, the assessment of management is inseparable from an evaluation of the quality of a business and the price paid compared with the value received. A low-quality business characterized by low margins, low returns on capital and a balance sheet loaded with debt requires excellent management and probably a little luck because a small slip could bankrupt the firm. If, however, a business has high margins, high returns on capital and no debt on the balance sheet, management mistakes are less likely to cause a disaster. Therefore, if we can't find the perfect managers, we prefer owning good businesses that leave some room for managerial imperfection.

For example, Midway owns **Legg Mason (LM)** and **Old Republic (ORI)** stock in its various portfolios. Legg Mason is an asset management business that typically generates a lot of cash compared with the capital invested in the business. It has historically been a very good business. This business model is far more resistant to poor management decisions than an insurance business like Old Republic. Old Republic has a lot of capital tied up in the business compared with its free cash flow. Insurance has some characteristics that resist disaster, but it would only take a few awful decisions by management to cause the firm extreme distress. It follows that good management at Old Republic is more important than good management at Legg Mason. We wouldn't have considered shares of ORI without its exceptional team headed by Aldo Zucaro and a large margin of safety. If the CEO of Old Republic were to switch places with Legg's CEO, our view of Legg Mason would hardly change – but our view of Old Republic would change dramatically.

At Midway, we avoid situations that require a herculean management effort to produce a decent result. To account for the possibility of mistakes – by us or by the company – we demand a margin of safety, which could be in the form of a bargain price, a high quality business, a great management team, or all three. We don't want to lose money due to the inevitable difficulties of running a business.

Our current holding **Dow Chemical (DOW)** offers a good example. Since we began buying Dow in December of 2008, it has gone through some monumental changes. We did not foresee all of the events that would subsequently transpire, nor did we value the company to perfection. But Dow is a good

business. It has high margins, the ability to turn inventory and it can adjust to changing commodity prices. Plus, we paid less than half of what we thought Dow was worth at the time. The key is to get the big ideas correct and let the margin of safety take care of smaller errors that are bound to occur when dealing with countless variables that are in constant flux.

And on that note, we'll end this letter by saying what a privilege it is to be your investment advisor. As always, please feel free to contact us anytime for any reason. We look forward to talking to you soon.

Yours,

Rachel Barnard

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